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Permanent establishment: to be or not to be, that is the question

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Recent case law

A leading low-cost airline has recently been sanctioned by labour inspectors from the local labour office *Direzione provinciale del lavoro* (DPL), which reportedly imposed an administrative fine for failure to pay social security contributions in Italy.

The DPL alleged that the airline had hired 650 employees in Ireland, despite the fact that their employment activity was to be performed entirely in Italy, thereby saving a considerable amount, since the applicable Irish social security contributions were significantly lower than those payable in Italy.

The labour inspectors have therefore asked the National Social Security Institute – the *Istituto Nazionale della Previdenza Sociale* (INPS) – to issue a formal demand for nearly €12 million.

The measures in question were taken following reports from the trade union representatives of flight attendants, who complained about differential treatment as a result of different social security obligations.

The administrative proceedings are still ongoing, as the airline in question has challenged the imposition of the administrative fine. The case has a number of potentially significant implications for foreign companies.

Essentially, the issue relates to the ability of a foreign company with an established base in Italy to hire employees under the law of a foreign jurisdiction and to pay social security contribution under that foreign regime, even if – for practical purposes – the employees work in Italy and make use of the healthcare services provided there. In these circumstances, the employees effectively benefit from public services in Italy without a corresponding contribution being made.

Thus, a payment order from the INPS would be based on the rule whereby employees are subject to the Italian system of social security contributions if they work in Italy and if they do so for a foreign company that has a permanent establishment in Italy.

A similar case in France, several years ago, led to the closure of an airline's business in that country. The airline in question decided to alter its business operations in order to avoid the application of French law to its employment agreements, with a number of negative economic consequences.

Permanent establishment

The concept of 'permanent establishment' originates in tax law, being applied so that income deriving from business activities carried out by a foreign enterprise in a given state may be subject to taxation in that state.

Article 162 of the Italian Tax Decree (Presidential Decree 917/1986) defines the term 'permanent establishment' for the purposes of direct taxation. In this context, it refers to the ongoing (not merely occasional) performance of a business activity in Italy by a foreign tax-resident enterprise, and must always be construed in accordance with any definition provided by a relevant tax treaty (if any). In simple terms, Article 162 provides that a permanent establishment may consist of:

(i) a fixed base of business, through which a foreign tax-resident enterprise wholly or partly carries out its business activities in Italy (eg, a branch or office); or
(ii) a legal or natural person that habitually has and exercises in Italy the authority to conclude contracts on behalf of the foreign enterprise.

Section 11 of EU Regulation 282/2011 (which came into effect in July 2011) introduced a definition of permanent establishment that applies for value added tax purposes only. This definition requires:

(i) a sufficient degree of permanence;
(ii) the involvement of human and technical resources; and
(iii) the capacity on the part of the fixed base to provide and receive goods and services for its own benefit.

Several Supreme Court decisions have referred to a "centre of permanent activity" rather than a "permanent establishment", thereby stressing the notion of a single locus of **legal** relationships, rather than the physical permanence of business activities in the Italian territory.

Applicable law

Based on these principles, where an economic activity is considered to constitute a permanent establishment in Italy, it is subject to tax and social security obligations pursuant to Italian law.

Nevertheless, even if a company does not have a permanent establishment in Italy and does not pay taxes there, it must comply with Italian laws in registering the contributory position of the employees who perform their activity in Italy. In order to do so, it must provide the necessary information to:

- the INPS in respect of pensions and other economic measures, such as for unemployment support and maternity benefits; and

- the National Institute on Statutory Workers' Insurance – the *Istituto Nazionale per l'Assicurazione contro gli Infortuni sul Lavoro* – for the delivery of financial and medical measures in the event of workplace injury or occupational illness.

For these purposes, the foreign company must appoint a social security representative in Italy (usually a payroll provider or an accountant) in order to complete the necessary registrations and comply with its obligations under Italian labour law.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.